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[redacted]

Escalating Tensions--New Threats to Oil Flows

Despite current oil market calm, the risks to shipping have escalated since the early days of the tanker war due to a variety of factors and, in our view, the oil market remains vulnerable to a supply disruption. 2/ Acquisition by Iran of the Silkworm anti-ship missile, which has substantially more destructive capacity than Exocet missiles, has increased concern about potential loss of life and oil supplies. Iran has not yet used this missile against tankers, but it may be capable of sinking crude carriers; Iraq also has acquired weapons with substantially more destructive capability. Moreover, the Iranians apparently have placed mines in channels approaching Kuwait's major export terminal at Mina al-Ahmadi in recent weeks, which has added a new threat to shipping. This threat was sufficient to at least temporarily halt liftings by Japanese-crewed tankers from the Neutral Zone. [redacted]

Iranian rhetoric has become increasingly belligerent since discussions of Kuwaiti chartering of three Soviet vessels and Kuwaiti-US plans to reflag 11 vessels became public. Iran has in the past year been implicated in several terrorist attacks against Kuwait's oil facilities. More than two-thiras of the excess production capacity that has helped to keep the market calm is in the Persian Gulf and these attacks have demonstrated again the vulnerability of these facilities to sabotage. Gulf countries with significant Shi'a populations have been reminded of the potential internal danger from radical elements supported by Iran. We believe the escalating tensions and uncertainty about future Iranian actions and superpower responses have caused a reaction in the oil market in recent months: spot oil prices probably are slightly higher than would otherwise be the case, and some precautionary building of commercial stocks may be occuring. [redacted]

[redacted]

Iran and the Superpowers. Iran fundamentally opposes Kuwait's request for superpower assistance and the increased US-USSR presence in the Gulf. We cannot accurately predict Iranian actions but, at a minimum, Tehran wants to intimidate Kuwait into withdrawing its request to the superpowers for assistance. Iran has a wide variety of options in acting to achieve its goals. Some of these include: attacking vessels enroute to or from Kuwait; stepping up the level of attacks on general shipping in the Gulf; diverting attacks to vessels calling at Saudi or UAE ports; instigating terrorist or even direct attacks against key production and export facilities in other Gulf states. If Iran begins to escalate shipping attacks or attacks on oil facilities, uncertainty about events almost certainly would cause at least a temporary rise in spot oil prices, even without a physical supply shortfall. [redacted]

Tehran would have to use essentially all of its air, naval, and terrorist capabilities to attack tankers, appear to mine the Strait of Hormuz, or to systematically attack critical oil installations throughout the Gulf to cause a major real shortfall in free world oil supplies. [redacted] But it faces significant limitations in its ability to conduct an effective attack that would seriously disrupt oil flows. Effective terrorism or sabotage strikes, however, are well within Iran's ability. Also, Saudi, Kuwaiti, and other Gulf state oil facilities remain vulnerable to Iranian attack despite efforts to improve protection (Figure 3). An Iranian decision to act, and effective strikes against Saudi export terminals at Ras Tanura and Ju'aymah, could limit Saudi exports to less than 3 million b/d through Yanbu on the Red Sea. An attack on Saudi facilities and disruption in Gulf exports through the Strait could remove about 7 million b/d of oil supplies from the market--more than double surplus capacity outside the Gulf. Assuming Iran was unable to repeat attacks, however, a prompt repair effort could partially restore oil flows within several months. [redacted]

Market Implications

In our judgment, the probability of a supply disruption serious enough to cause a sustained net loss to world oil supplies is low given Iranian military capabilities, current market conditions, and potential offsets. The market reaction to an escalation of attacks on shipping or an all-out Iranian attack on oil facilities in other Gulf states would depend on several key factors: the actual physical loss of supplies or production capability; expectations

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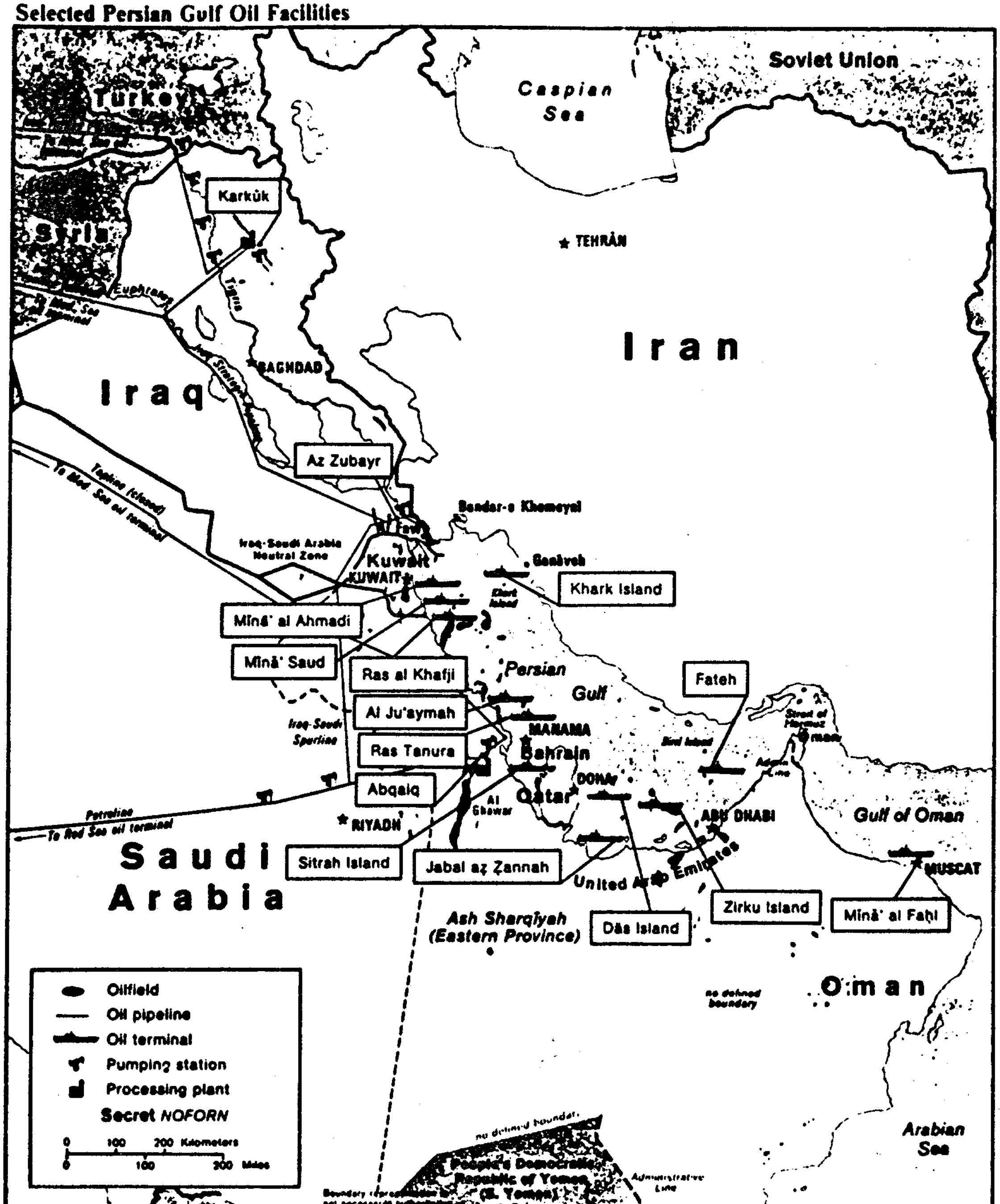
Figure 3
Selected Persian Gulf Oil Facilities



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about further damage; expectations about the duration of the supply loss; US, Allied and Gulf states responses, including decisions on the use of oil stocks. [redacted]

Even without a net supply shortfall, a temporary price rise would result from the psychological market reaction. In the less likely event of a major disruption that includes Saudi Arabia and other northern Gulf producers, the market would suffer a net supply shortfall and the price impact would be much greater. The price increase would depend both on the length of the disruption and the extent to which oil production capacity was repaired to predisruption levels. We cannot accurately predict how high world oil prices might rise in this case, because the oil market has never experienced such a substantial supply loss. The economic losses to consuming nations, however, would be substantial. [redacted]